

A Quixotic Crusade for Common Sense? A Path to Getting Paid to Wait While Serving Up Critical Diversification Needs

Yet after the world's most valuable chipmaker smashed expectations with its blowout report Wednesday, the AI party is one nobody can afford to miss. Short interest is nearly nonexistent among tech behemoths. ...

For active managers, the pressure is getting more intense by the day to ride the upward momentum across tech-powered indexes like the S&P 500 and Nasdaq 100 ...

In turn, the Nasdaq 100's price-earnings ratio climbed above 30x...[a] figure with few precedents outside the late 1990s dot-com craze.... Among hedge funds, the latest 13F reports revealed another increase in the share of ownership of the group. Retail traders are also driving the action, with demand for bullish options reminiscent of the pandemic-era trading boom.

So said [Denitsa Tsekova](#) and [Carmen Reinicke](#) in their superb article [Bubble Hunters on Wall Street Crushed as AI Trade Conquers All](#). What their Bloomberg piece did better than any other we have seen is encapsulate the powerful confluence of forces that have sent the "AI Complex" soaring. Let's summarize in three bullets:

- You definitely can't short AI and stay solvent
- If you're a long-only active manager and you are not in AI, you have been or are about to be sacked
- Retail speculative activity on AI names is reminiscent of the behavior seen in 2020 and 1999

In our view, these are some of the least appealing reasons we can think of to own a stock. For a sense of sheer scale, we provide the market cap to GDP of the 30 largest American companies below. America's top 30 made a new record high in December of 2021.

In 2022, the popular 60/40 diversification strategy had its [worst performance](#) since the Great Depression, and investors learned....nothing. Off to the races again.

Market Cap of 30 Largest Stocks/GDP



Source: Kailash Capital Research, LLC; Data from 1/31/1981 - 1/31/2024

Long-time KCR readers are familiar with our work on the arithmetic issues facing today's "Nifty Fifty", the [bubble](#) in junk stocks that peaked in 2020, and the increasingly severe risks to investors from [concentration](#).

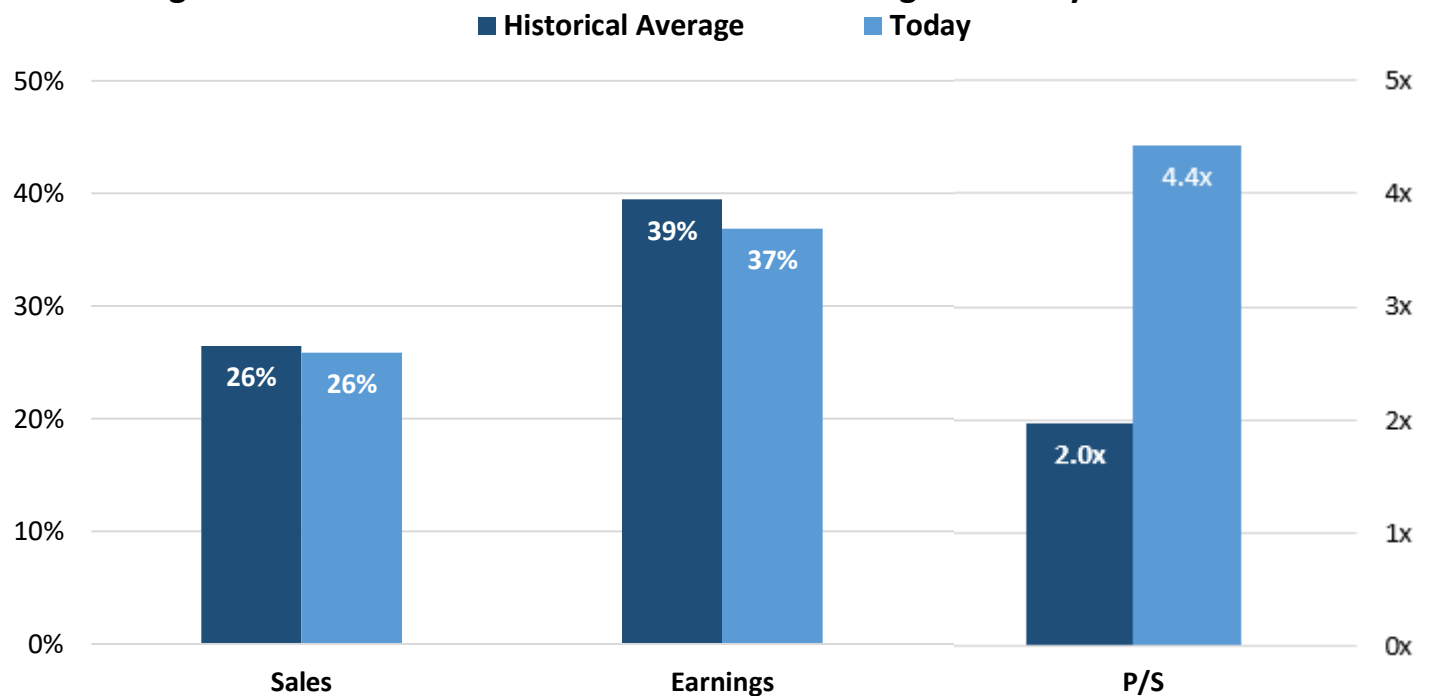
We are obviously not alone in these concerns. We urge our readers to peruse the brilliant work of the wonderful folks at [Capital Group](#) and [Clearbridge](#). While slightly different in construction, both pieces use clear charts to explain that while this recent mega-cap run may be fun, the importance of diversification has rarely been higher.

KCR will try to use the one simple chart below to highlight the major problem with the 30 mega-cap stocks that have single-handedly soared since the start of 2023.

Let's start with the **navy blue bars** and move from left to right.

- First bar: the **sales** of the 30 largest companies in the Russell 1000 Index have historically averaged 26% of the index's total sales [*total sales of the 30 largest stocks divided by total sales of all stocks in the Russell 1000 index*]
- Next navy blue bar, those 30 largest companies typically averaged 39% of the index's total profits
- Last navy blue bar shows that the 30 largest firms are typically valued at 2x price to sales

The 30 Largest Stocks in the Russell 1000: Historical Average vs. Today



Source: Kailash Capital Research, LLC; Data from 1/31/1981 - 1/31/2024

Next to each navy blue bar is the **current** value for the largest 30 stocks in **light blue**. **What do we see?**

The 30 largest companies look like they are contributing nothing more than their historical average in terms of sales and profits to the overall index's sales and profits.

The big difference is in the two bars on the right - the multiple today is over 100% higher than the historical average.

There's another investor with a solid track record who said something similar recently about supersized companies. The below is from Mr. Buffett's recent letter to investors (**bold** emphasis ours):

Our goal at Berkshire is simple: We want to own either all or a portion of businesses that enjoy good economics that are fundamental and enduring. Within capitalism, some businesses will flourish for a very long time while others will prove to be sinkholes. It's harder than you would think to predict which will be the winners and losers.

*There remain **only a handful of companies** in this country capable of truly moving the needle at Berkshire, and they have been endlessly picked over by us and by others. Some we can value; some we can't. And if we can, they have to be attractively priced.*

*If you believe that American investors are now more stable than in the past, think back to September 2008. Speed of communication and the wonders of technology facilitate instant worldwide paralysis... **Such instant panics won't happen often – but they will happen.***

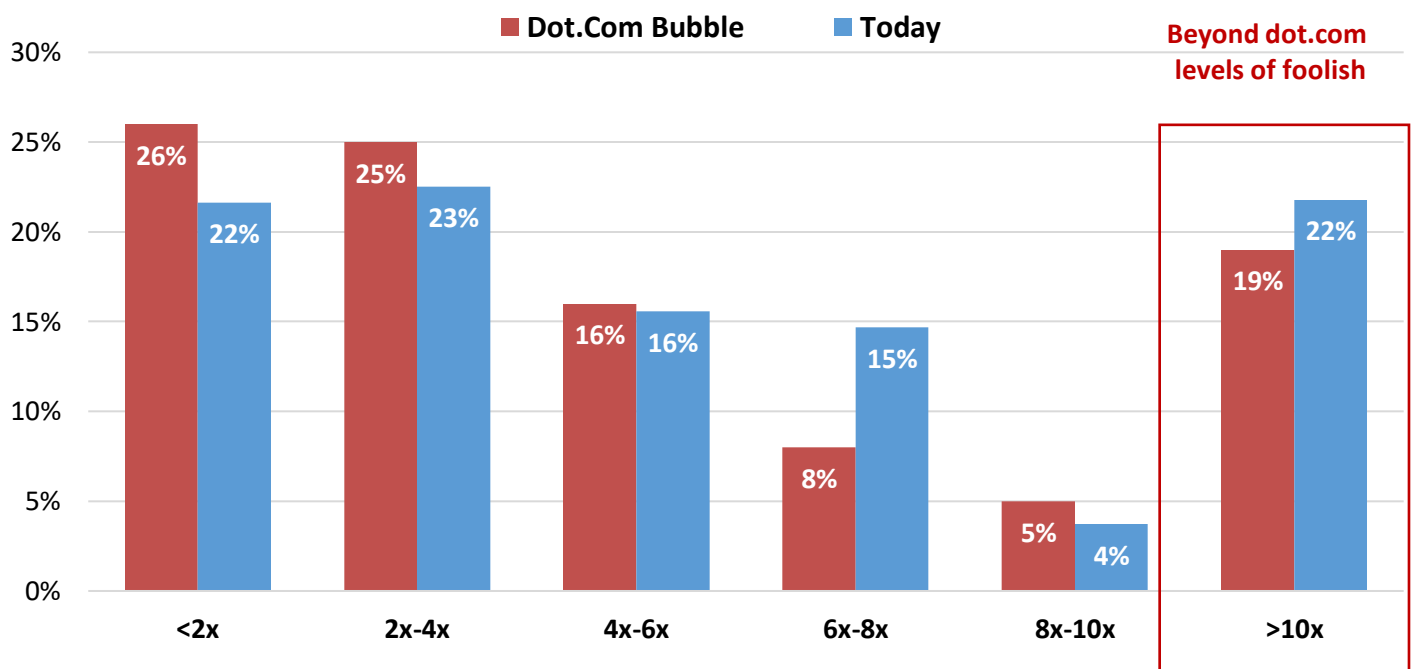
*Though the stock market is massively larger than it was in our early years, **today's active participants are neither more emotionally stable nor better taught than when I was in school.** For whatever reason, **markets now exhibit far more casino-like behavior than they did when I was young.** The casino now resides in many homes and daily tempts the occupants.*

So one of the greatest investors in the world, who is now sitting on \$167 billion, the [largest cash pile](#) in Berkshire's history, is telling us:

1. Berkshire is so big, the only place for him to hunt for stocks is among a handful of the largest companies
2. There's nothing of interest to him at the moment because those companies are too expensive
3. But beware, the speculative fervor in markets today will, at some point, become panic, and then the opportunities will emerge

In our piece [Large Cap Core: Growth Funds in Hiding](#) we explained that the "growth" tilt due to these expensive mega-cap stocks had "infected" even core benchmarks in a manner last seen at the peak of the dot.com bubble. We have updated the key chart in that paper below. **Today, 22% of an investor's money in an index fund goes to stocks valued at over 10x price to sales. That is higher than December of 1999.**

Price/Sales: Percent of R1000 in Each Bucket



Source: Kailash Capital Research, LLC; Data from 12/31/1999 & 1/31/2024

Consistent with common sense, we have demonstrated there is [no empirically robust](#) method of making money buying stocks valued at over 10x price to sales.

By definition, if you own an index fund, you are making the biggest bet in history on a small number of stocks with massive market caps that Mr. Buffett just told you are not worth buying today. We have read numerous articles explaining how today differs from the dot.com bubble. That the mega-cap stocks that dominate index funds are abnormally profitable and are, therefore, reasonably priced.

So, who is right? The pundits or Mr. Buffett? We think Mr. Buffett’s track record on such topics is peerless. It is also consistent with the data.

One of the most interesting things Mr. Buffett emphasized in this shareholder letter was Coca-Cola, Occidental Petroleum, and American Express. As the world hyperventilates about AI, Mr. Buffett is talking about Staples, Energy and Financial stocks. All happen to have long histories of **paying dividends**.

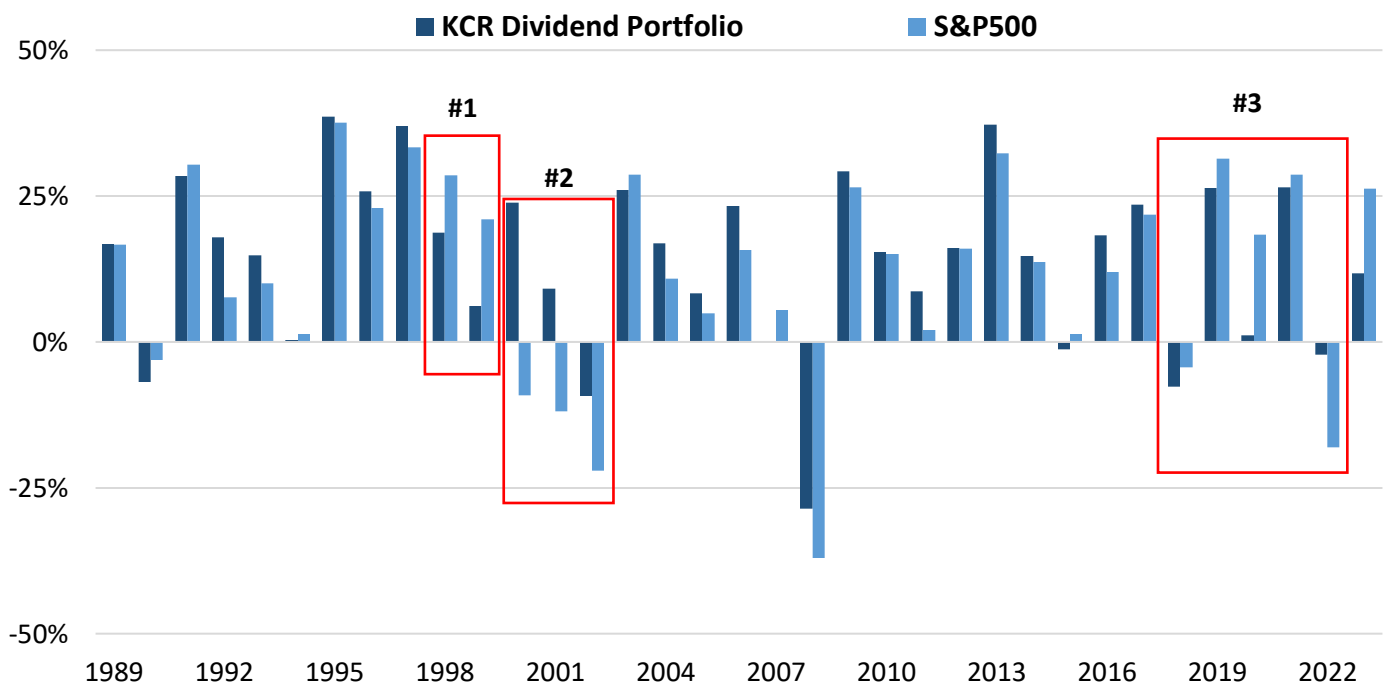
Post our last piece explaining the methodology behind [KCR’s Dividend Portfolio](#), we had several questions regarding the Model’s historical ability to diversify risk in the equity portion of an investment portfolio. The exhibits below surprised even us. **The diversification benefits are significant and primarily come from reducing downside risk.**

The chart below shows the gross returns of the **KCR Dividend Portfolio** and the **S&P 500** by year. Considering the powerful analogs to the dot.com bubble, we will highlight the late 1990s and the period post the bubble bursting. Each bullet is annotated as explained:

1. In 1998 and 1999, **KCR’s Dividend Model Portfolio** lagged the **S&P 500** horribly
2. In 2000, 2001, and 2002, our book of prosaic dividend payers either **rose** or fell far less than the index
3. We note a similar behavior more recently when the dividend portfolio underperformed the S&P 500 in 2018, 2019, and 2020 before providing powerful downside protection in the sharp 2022 correction

You can see that most recently, in 2023, **KCR’s Dividend Model Portfolio** was trounced by the **S&P 500**.

Year by Year Returns



Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 12/31/2023

In the appendix we show the exact same chart but replace the S&P 500 with the Russell 1000 Growth Index and the Russell 1000 Value Index respectively.

We see potent diversification benefits across all three benchmarks.

We can summarize these benefits by calculating the average return of **KCR's Dividend Model Portfolio** and the benchmarks in years when the S&P 500 was up (first four bars) and down (last four bars).

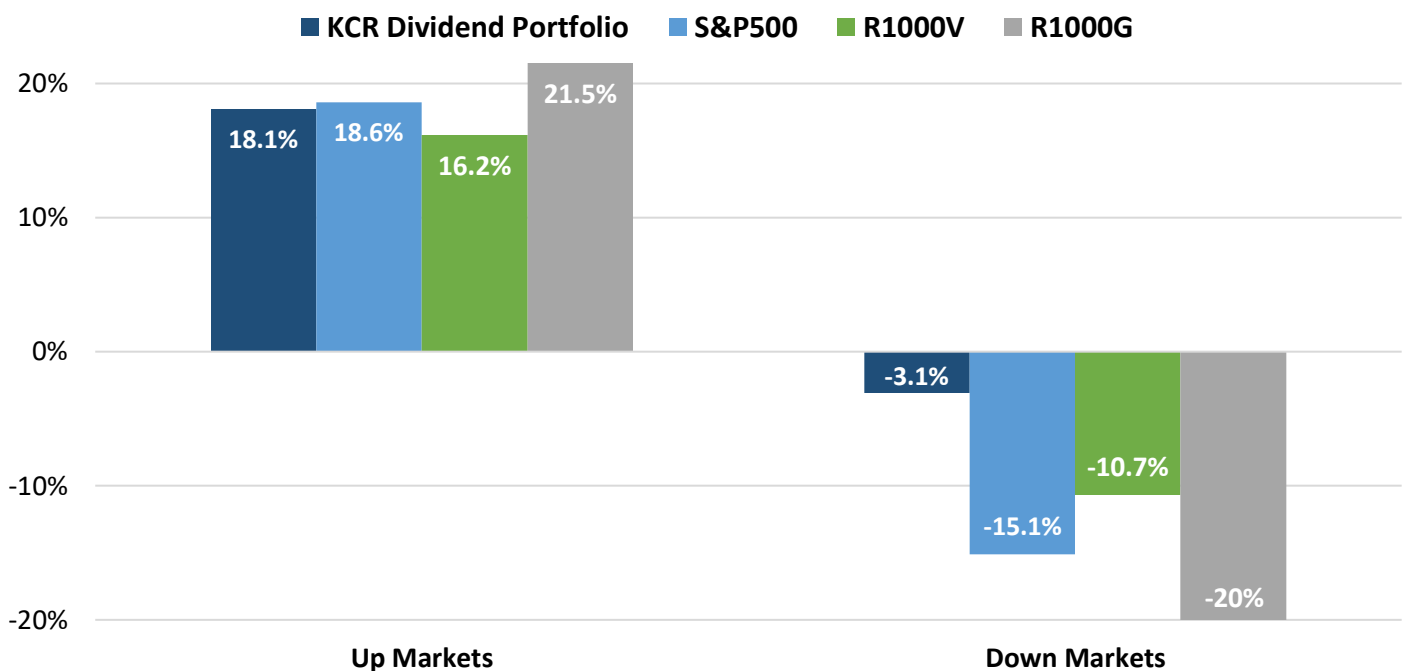
The first four bars on the left show that when the S&P 500 is up:

KCR's Model Dividend Portfolio has risen 18.1%, on average while the **S&P 500** rose 18.6%, the **Russell 1000 Value** rose 16.2%, and the **Russell 1000 Growth** index rose 21.5%.

The last four bars on the right show that when the S&P 500 is down:

KCR's Model Dividend Portfolio has fallen only -3.1% on average. In comparison, the **S&P 500** fell -15.1% while the **Russell 1000 Value** and **Growth** benchmarks fell -10.7% and -20% respectively.

Average Absolute Return in Up and Down Markets by Calendar Year



Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 12/31/2023

Very simply, KCR's quality-focused approach to sourcing dividend income has historically been a relative underperformer in up years while offering investors significant downside protection. We are not an all-or-nothing team. We understand and believe in the value of cheap beta.

But as we have discussed in our recent papers, we believe today may be an opportune moment to own equities that "pay you to wait" and don't rely on the animal spirits of others.

In the table below we compare the S&P 500, the Russell 1000 Value Index, and KCR's Dividend Portfolio at the peak of the dot.com bubble (top three rows) and today (bottom three rows). **We find it remarkable that the spreads today on valuations and payouts look equal to, if not wider than at the dot.com peak.**

		Dividend		P/S	EV/Sales	P/E	ROE	Net Margins	Total Yield	Net Debt/ Price*	3 Yr Sales Grth	3 Yr Earnings	
		Yield	FCF/EV*									Grth	Grth
Dot.Com Peak	S&P500	1.0%	1.8%	2.3x	3.1x	31.0x	21%	12%	2%	29%	108%	107%	1.12
	R1000V	1.8%	2.5%	1.4x	2.1x	20.5x	19%	8%	3%	59%	80%	79%	0.96
	KCR Dividend Portfolio	2.3%	6.3%	1.0x	1.5x	14.0x	28%	10%	6%	23%	38%	75%	0.98
Today	S&P500	1.4%	3.2%	2.6x	3.0x	25.1x	40%	19%	3%	12%	54%	130%	1.05
	R1000V	2.4%	3.7%	1.7x	2.0x	19.5x	16%	13%	4%	26%	42%	102%	0.91
	KCR Dividend Portfolio	3.6%	7.9%	1.1x	1.2x	12.1x	30%	14%	7%	21%	38%	91%	0.87

Source: Kailash Capital Research, LLC; Data from 1/31/2024; *ex financials

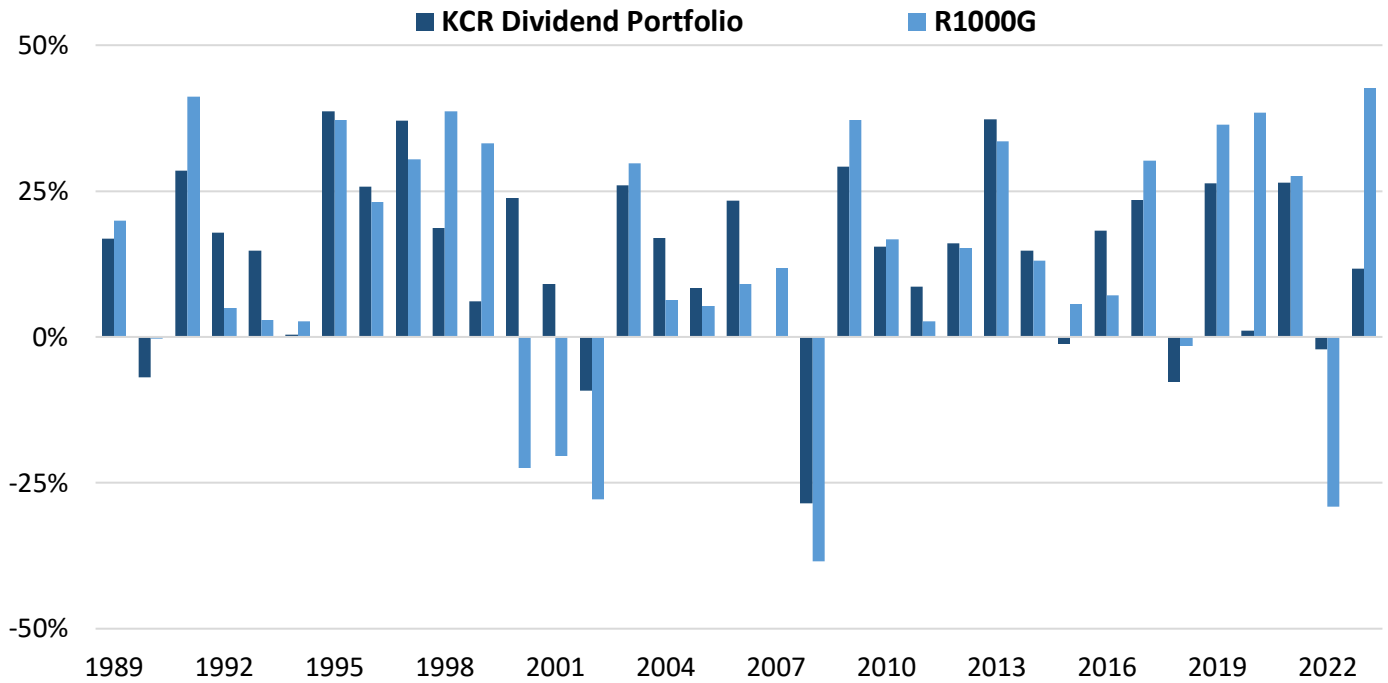
The purpose of this paper is not to exhort people to sell their index funds or to try and “hunt a bubble.” Our goal here is a humble one. Let’s lay it out in three bullets:

1. Mega-cap US stocks are now a consensus “buy” among hedge funds, active investors, and retail
2. While great companies dominate these mega-caps, their elevated valuations have created unusual concentration risk for investors in passive products
3. There are simple and common-sense methods to diversify that risk without doing anything exotic

Adding exposure to a high-quality dividend strategy may be one of the easiest and most obvious ways to mitigate concentration and valuation risks that dominate passive products.

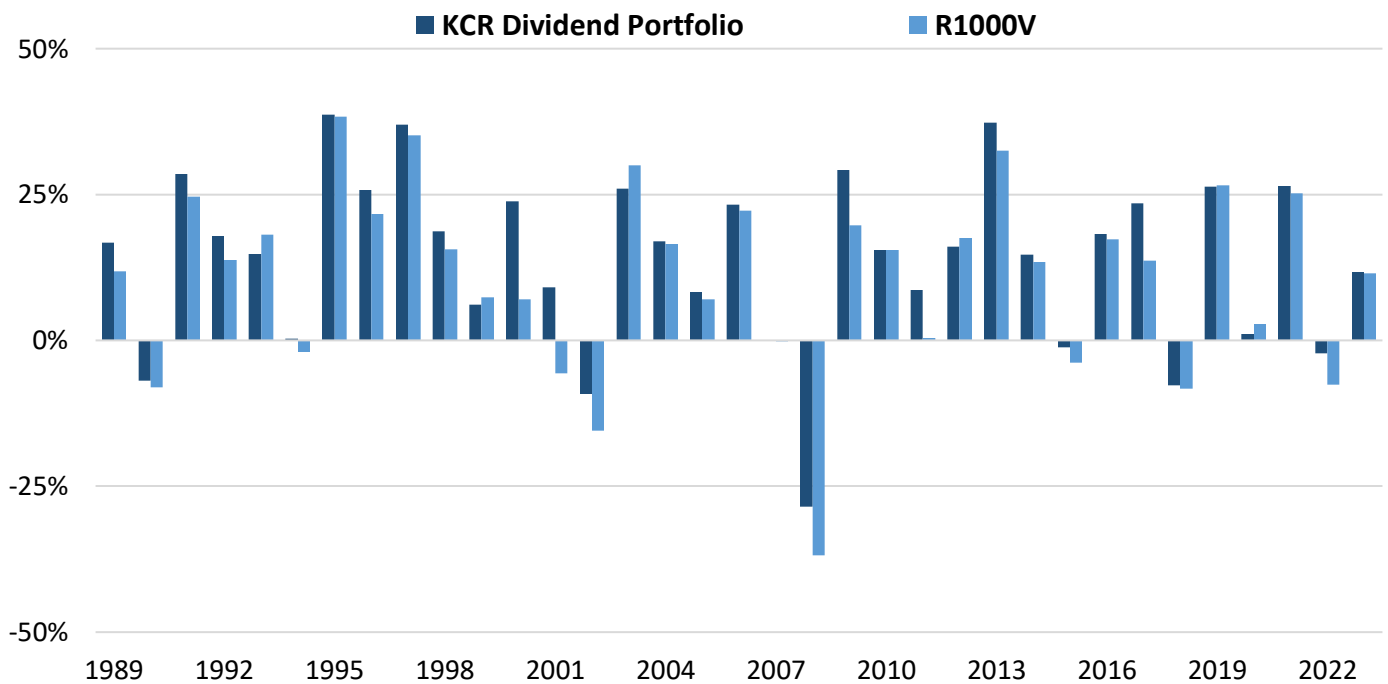
Appendix

Year by Year Returns



Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 12/31/2023

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Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 12/31/2023

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